

UNITED STATES BANKRUPTCY COURT  
FOR THE WESTERN DISTRICT OF NORTH CAROLINA  
Shelby Division

**FILED**  
U.S. Bankruptcy Court  
Western District of NC

NOV - 2 2004

David E. Welch, Clerk  
Charlotte Division  
KRT

In Re:

JEFFREY SCOTT HAMRICK  
fdba S&S CONSTRUCTION  
dba K&H PROPERTIES, dba  
FORCE PRO SHOP  
PENNY LYNN HAMRICK

Debtors.

Case No. 03-40009  
Chapter 7

JUDGMENT ENTERED ON NOV - 2 2004

JEFFREY SCOTT HAMRICK  
PENNY LYNN HAMRICK

Movants,

v.

C. BRIAN DEAL, REVENUE OFFICER,  
NORTH CAROLINA DEPARTMENT OF  
REVENUE and E. NORRIS TOLSON,  
SECRETARY OF THE NORTH CAROLINA  
DEPARTMENT OF REVENUE

ORDER DENYING MOTIONS FOR SANCTIONS AND SETTING MATTER FOR  
CONTINUED HEARING REGARDING PAYMENTS MADE BY THE DEBTORS TO THE  
NORTH CAROLINA DEPARTMENT OF REVENUE

This matter came before the court upon the debtors' Motion for Sanctions, the response thereto of the North Carolina Department of Revenue (the "NCDOR"), and the NCDOR's Motion for Sanctions. After consideration of these motions and the arguments of counsel, the court has concluded that the debtors' Motion for Sanctions should be DENIED because the debtors' 1992 tax liability was excepted from discharge under 11 U.S.C. § 523(a)(1)(B)(i). Therefore, the NCDOR did not violate the discharge injunction by attempting to collect

the debtors' 1992 tax liability. In addition, the court has concluded that the NCDOR's Motion for Sanctions should be DENIED.

#### **FINDINGS OF FACT**

1. On or about March 8, 1993, the debtors filed a North Carolina individual income tax return for the year 1992 with the assistance of an accountant. The 1992 individual income tax return reflected \$-2,912.00 in North Carolina taxable income and a refund due in the amount of \$356.00.

2. Subsequent to the filing of their 1992 state and federal individual income tax returns, the debtors were notified by the Internal Revenue Service ("IRS" or "Service") that it was going to conduct a federal examination of the debtors' books and records for the 1992 tax year.

3. The debtors retained Darryl Keller, a Certified Public Accountant with the accounting firm of Brown, Keller & McKinney in Kings Mountain, North Carolina, to represent them in the audit and examination to be conducted by the IRS.

4. Following the completion of its audit, the IRS sent the debtors a document titled Income Tax Examination Change dated September 16, 1994. This document, which is commonly referred to as a Revenue Agent's Report (hereinafter "RAR"), reflected the Service's adjustment of the debtors' taxable income for the tax year 1992 to a positive \$43,664.00. The bottom of the RAR contained the following statement: "The Internal Revenue Service

has agreements with State tax agencies under which information about Federal tax, including increases or decreases, is exchanged with the States. If this change affects the amount of your State income tax, you should file the State forms."

5. The IRS sent the NCDOR a State Abstract of the RAR, which reflected the IRS's adjustment of the debtors' taxable income for the tax year 1992.

6. Subsequently, Brown, Keller & McKinney prepared and filed a new 1992 Federal individual income tax return for the debtors which reflected the changes reported in the RAR. However, neither the debtors nor their accountant prepared or filed a new 1992 North Carolina individual income tax return reflecting the federal changes in taxable income. At the hearing on this matter, the debtors testified that their accountant never advised of them of the requirement to file an additional return with the NCDOR reflecting the increased assessment for the tax year 1992.

7. Because the debtors failed to file a new state income tax return reporting the corrected income for the tax year 1992, the NCDOR issued a proposed assessment on June 5, 1997, in the amount of \$3,634.49. When the debtors failed to protest the proposed assessment within 30 days, the assessment became final, due, and payable.

8. After the issuance of the assessment, the debtors entered into a payment plan with the NCDOR, whereby they agreed to make

payments of \$200.00 per month beginning in December, 1997. At the hearing on this matter, the debtors testified that they paid approximately \$3,000.00 towards the 1992 assessment through the payment plan.

9. The debtors subsequently defaulted on their payments. Consequently, on June 10, 2002, the NCDOR sent the debtors a notice advising them that their bank account had been garnished, and through the garnishment the NCDOR collected approximately \$1,000.00 from the debtors' bank account.

10. On January 3, 2003, the debtors filed a voluntary petition for relief under Chapter 7 of the United States Bankruptcy Code. The debtors listed the NCDOR as a general unsecured creditor on Schedule F holding a claim in the amount of \$4,000.00 for 1992 and 1993 taxes.

11. On April 18, 2003, this court entered an Order of Discharge in this case, which discharged all debts dischargeable under 11 U.S.C. § 727. The NCDOR was served a copy of the Order of Discharge.

12. Following the issuance of the debtors' discharge and the termination of the automatic stay provisions of 11 U.S.C. § 362, on May 13, 2003, the NCDOR sent the debtors a Notice of Collection Fee and Collection Agency Referral seeking payment in the amount of \$3,279.78, the balance due and owing on the debtors' 1992 individual income tax liability.

13. On August 22, 2003, the IRS notified the debtors that it had applied \$875.00 of the debtors' 2002 federal income tax refund toward their outstanding state tax obligation for 1992 individual income taxes.

14. In addition, on September 15, 2003, the NCDOR notified the debtors that a tax warrant had been issued in the amount of \$2,3332.50, representing outstanding taxes assessed for the period 1992.

15. In response to the NCDOR's demands for payment, the attorney for the debtors sent the NCDOR a letter advising the agency that its collection efforts were in violation of the automatic stay of 11 U.S.C. § 362 and other laws and requested that all demands for collection be withdrawn, dismissed, and canceled within ten days of receipt of the letter.

16. As it believed the automatic stay was no longer in effect and the 1992 tax liability had been excepted from the debtors' discharge pursuant to 11 U.S.C. § 523(a)(1)(B)(i), the NCDOR did not discontinue its collection efforts. In fact, on January 13, 2004, the NCDOR Sent a Garnishment for Taxes to the female debtor's employer, the Kings Mountain City Board of Education, wherein the NCDOR began to garnish her wages to pay the 1992 income tax liability. The NCDOR received approximately \$420.00 by garnishing Mrs. Hamrick's wages.

17. Moreover, on April 23, 2004, the IRS paid the NCDOR \$2,130.56, which would otherwise have been due to the debtors as a 2003 federal income tax refund. In addition, the NCDOR sent the debtors a Notice of Individual Income Tax Adjustment indicating that the NCDOR had retained the debtors tax year 2003 income tax refund of \$23.00.

18. Finally, the debtors received two Notices of Individual Income Tax Adjustments from the NCDOR dated May 23, 2004, and May 30, 2004, concerning their 1992 taxes. In the notice dated May 23, 2004, the NCDOR indicated taxes due for the year 1992 of \$2,670.00, for which \$5,793.03 was shown as having been paid. This rendered an overpayment of \$3,123.03. From this sum, the NCDOR showed a refund due of \$3,123.03 and, without explanation, subtracted therefrom the sum of \$2,915.43, leaving the debtors with a "net refund" of \$207.60.

19. In contrast, the May 30, 2004, Notice changed the amount of the overpayment from \$3,123.03 to \$3,015.96 but continued to subtract therefrom the unexplained sum of \$2,915.43, leaving a "net refund" due to the debtors in the amount of \$100.53.

20. In an attempt to summarize the monies owed and paid by the debtors to the NCDOR for the 1992 taxes, at the hearing on this matter, the NCDOR introduced a statement from Angela C. Fountain, Manager, Bankruptcy Unit, Collection Division, North Carolina Department of Revenue. This statement shows a taxable amount of

\$2,670.00. Added thereto are penalties of \$1,601.52 and interest of \$2,248.41 for a total due of \$6,519.93. From this sum, the NCDOR subtracted penalties waived of \$934.50, a 2003 offset of \$23.00, and payments of \$5,770.03, leaving an "overpaid" amount of \$207.60 to be refunded to the debtors. The NCDOR's statement does not appear to agree with the testimony and documentary evidence presented by the debtors. In addition, the statement does not explain the \$2,915.43 subtracted by the NCDOR from the debtors' refund due on the May 23 and May 30, 2004, Notices of Individual Income Tax Adjustment.

21. Due to the NCDOR's continued collection efforts, on April 16, 2004, the debtors filed a Motion for Sanctions against the respondents requesting that the court hold the NCDOR in contempt of court for violating the April 18, 2003, discharge order.

22. The NCDOR filed a response in which it asserted that it did not begin its collection efforts against the debtors until after they received their discharge and the § 362 automatic stay terminated. Moreover, the NCDOR argued that its collection efforts were not a violation of the discharge injunction because the debtors never filed a state income tax return as required by law. Therefore, the tax liability assessed against the debtors for 1992 was excepted from discharge pursuant to 11 U.S.C. § 523(a)(1)(B)(i).

23. In addition, on August 10, 2004, the NCDOR filed a Motion for Sanctions asking the court to impose sanctions against the debtors "for the continued prosecution of a frivolous motion for sanctions against Revenue . . . ." In its motion, the NCDOR asserted that the debtors had no reasonable basis for pursuing the prosecution of their motion for sanctions against the NCDOR in light of the facts and the law, which had been thoroughly discussed with counsel for the debtors.

#### CONCLUSIONS OF LAW

1. The critical issue in this case is whether the NCDOR violated the April 18, 2003, Order of Discharge and the permanent injunction established by 11 U.S.C. § 524(a) by attempting to collect the 1992 tax liability post discharge.

2. N.C. Gen. Stat. § 105-159 provides that "[i]f a taxpayer's federal taxable income is corrected or otherwise determined by the federal government, the taxpayer must, within two years after being notified of the correction or final determination by the federal government, file an income tax return with the Secretary reflecting the corrected or determined taxable income."<sup>1</sup>

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<sup>1</sup>The most recent version of N.C.G.S. § 105-159 became effective January 1, 1995, and applies to assessments of taxes for which the statute of limitations had not expired on or before January 1, 1995. Pursuant to N.C.G.S. § 105-241.1(e), "[i]f there is a federal determination and the taxpayer does not file the required return, the Secretary must propose an assessment of any tax due within three years after the date the Secretary received the final report of the federal determination." See N.C.G.S. § 105-241.1(e) (2003). Because the federal assessment was issued in this case on September 16, 1994, the statute of limitations for the Secretary to propose an assessment did not run until



See N.C.G.S. § 105-159 (2003) (effective Jan. 1, 1995). This statute unequivocally requires tax payers to file a new or amended tax return with the NCDOR following a reassessment by the IRS.

3. In this case, there is no dispute about the fact that the IRS provided the debtors with an Income Tax Examination Change dated September 16, 1994, which adjusted the debtors' taxable income for the tax year 1992 to a positive \$43,664.00 from a negative \$-2,912.00. In addition, there is no dispute about the fact that the debtors never filed the "required return" with the NCDOR reflecting the adjusted taxable income for 1992.

4. 11 U.S.C. § 523(a)(1)(B)(i) provides that "[a] discharge under section 727 . . . of this title does not discharge an individual debtor from any debt . . . for a tax or a customs duty . . . with respect to which a return, if required . . . was not filed." See 11 U.S.C. § 523(a)(1)(B)(i). Thus, the debtors 1992 tax year liability was excepted from the April 18, 2003, Order of Discharge because they failed to file the return required by N.C.G.S. § 105-159. Consequently, the NCDOR did not violate the discharge injunction of 11 U.S.C. § 524 by proceeding to collect the 1992 tax liability following the debtors' discharge from bankruptcy.

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three years later, on September 16, 1997. Thus, the current version of N.C.G.S. § 105-159 applies to this case because the statute of limitations for an assessment by the Secretary did not expire on or before January 1, 1995.

5. The court is bolstered in its decision by the In re Cannon case, Case No. 95-00555-8-JRL (Bankr. E.D.N.C. 1999), which was decided by the Honorable J. Rich Leonard, United States Bankruptcy Judge for the Eastern District of North Carolina. In Cannon, the debtor filed a timely individual income tax return for the 1989 tax year, which reported a taxable income of negative \$-4,700. The IRS subsequently sent the NCDOR a State Abstract of a document titled Income Tax Examination Changes, which reflected the IRS's adjustment of the debtor's 1989 taxable income to \$19,286. The NCDOR sent a collection letter to the debtor regarding his 1989 individual income tax liability after he had received a discharge in bankruptcy. In response, the debtor filed a motion in the cause asking that the court find that the NCDOR could no longer collect the 1989 tax liability.

6. Judge Leonard held that N.C.G.S. § 105-159 required the debtor to file a new 1989 income tax return to reflect the income adjustment made by the IRS. The debtor never filed this return, so the outstanding tax liability fell squarely within 11 U.S.C. § 523(a)(1)(B)(i). See Cannon at 3. Thus, the failure of the debtor to file a new or amended return after the federal correction was issued in compliance with N.C.G.S. § 105-159 resulted in a nondischargeable tax liability which could be collected by the NCDOR.

7. Judge Leonard's decision was upheld and affirmed by both the United States District Court for the Eastern District of North Carolina and the Fourth Circuit Court of Appeals. See Cannon v. North Carolina Dep't of Revenue, No. CA-99-2500 (4th Cir. Feb. 1, 2000); Cannon v. North Carolina Dep't of Revenue, No. CA-99-302 (E.D.N.C. July 21 & Oct. 5, 1999).

8. At the hearing on this matter, the debtors offered the testimony of Edward P. Bowers, Certified Public Accountant, who testified that it is the common practice of accountants in North Carolina not to file additional income tax returns with the North Carolina Department of Revenue once it has issued an assessment based upon an adjustment in the taxpayer's federal taxable income. Mr. Bowers testified that he was not aware of any accountants who would, after issuance of the NCDOR's assessment, go to what he described as a "needless effort" to file an additional North Carolina tax return. Mr. Bowers explained that the new or amended return would serve no useful purpose because the assessment issued by the NCDOR, in essence, constitutes the return.

9. In support of his argument, Mr. Bowers stated that he interprets N.C.G.S. § 105-241.1(e) as relieving the taxpayer of the affirmative obligation to file a return created by N.C.G.S. § 105-159 because § 105-241.1(e) initially provides no statute of limitations for the NCDOR to issue an assessment if the taxpayer has not filed a return. The statute subsequently creates a three

year statute of limitations within which the NCDOR must issue its own assessment if there is a federal determination and the taxpayer does not file the required return. Thus, he explained that the assessment issued by the IRS is deemed to be a return because of the three year statute of limitations imposed upon the NCDOR, obviating the need for a taxpayer to file his or her own return.

10. On cross examination, Mr. Bowers confirmed that N.C.G.S. § 105-159 creates an affirmative duty on the taxpayer to file a return with the NCDOR following the issuance of a federal assessment. Moreover, he admitted that there is no North Carolina law to support his interpretation of N.C.G.S. § 105-241.1(e) and N.C.G.S. § 105-159. And, in the absence of any law to the contrary, the court must rely on the plain language of the statutes. "'It is well established that when the statute's language is plain, the sole function of the courts-at least where the disposition required by the text is not absurd-is to enforce it according to its terms.'" See U.S. Dep't of Labor v. N.C. Growers Ass'n Incorporated, 377 F.3d 345 (4th Cir. 2004) (citation omitted).

11. At the hearing on this matter, the debtors shifted the responsibility for their failure to file the required return by testifying that their accountant did not advise them that they needed to file a new or amended return. Even assuming the debtors' accountant did not advise them to file a return with the NCDOR, his

failure to do so would not relieve the debtors of their duty to file a return under the statute. Moreover, the Income Tax Examination Change dated September 16, 1994, and issued by the IRS specifically stated that "[t]he Internal Revenue Service has agreements with State tax agencies under which information about Federal tax, including increases or decreases, is exchanged with the States. If this change affects the amount of your State income tax, you should file the State forms." This document specifically put the debtors on notice of their affirmative duty to file a new or amended income tax return for the tax year 1992.

12. In its Motion for Sanctions, the NCDOR seeks sanctions against the debtors for "the continued prosecution of a frivolous motion for sanctions". Although the court has determined it should deny the debtors' Motion for Sanctions, they should not be sanctioned for pursuing a novel argument regarding the interplay between N.C.G.S. §§ 105-159 and 105-241.1(e), which was supported by the testimony of Ed Bowers. Thus, because there were substantial issues of fact and law involved in the prosecution of the debtors' motion for sanctions, the court will deny the NCDOR's Motion for Sanctions.

13. Finally, at the hearing on this matter, the NCDOR presented the statement of Angela C. Fountain to summarize the monies owed and paid by the debtors to the NCDOR for the 1992 tax liability. There are significant differences between the statement

of the NCDOR and the evidence presented by the debtors at the hearing regarding the monies owed and paid by the debtors to the NCDOR. The court recognizes there are administrative proceedings the debtors could pursue to reconcile these amounts. However, the parties have already presented substantial evidence to this court regarding this issue. Therefore, in the interest of judicial economy, this court will conduct a continued hearing on January 28, 2005, at 9:30 a.m., United States Bankruptcy Court, Cleveland County Courthouse, 100 Justice Place, Shelby, North Carolina, 28150, to give both the debtors and the NCDOR an opportunity to present a clear and concise summary of the monies owed and paid by the debtors to the NCDOR for the 1992 tax liability.

It is therefore **ORDERED** as follows:

1. The debtors' Motion for Sanctions is denied;
2. The NCDOR's Motion for Sanctions is denied; and
3. The court will conduct a continued hearing on January 28, 2005, at 9:30 a.m., United States Bankruptcy Court, Cleveland County Courthouse, 100 Justice Place, Shelby, North Carolina, 28150, so the debtors and the NCDOR can present additional evidence regarding the monies owed and paid by the debtors to the NCDOR for the 1992 tax liability.

  
(Dated as of date entered)

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Marvin R. Wooten  
United States Bankruptcy Judge